

BEFORE THE
POSTAL REGULATORY COMMISSION

Periodic Reporting (Proposal Three)

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Docket No. RM2018-6

COMMENTS OF UNITED PARCEL SERVICE, INC. ON NOTICE
OF PROPOSED RULEMAKING ON ANALYTICAL PRINCIPLES
USED IN PERIODIC REPORTING (PROPOSAL THREE)
(June 29, 2018)

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United Parcel Service, Inc. (“UPS”) respectfully submits these comments in response to the Postal Regulatory Commission’s Notice of Proposed Rulemaking on Analytical Principles Used in Periodic Reporting (June 7, 2018) (“Order No. 4635”).

INTRODUCTION

This docket involves two proposed changes to how the Postal Service calculates the incremental costs of competitive products.¹ While UPS appreciates that the proposed changes are themselves relatively narrow and technical, they are part of, and necessarily implicate, the broader set of analytical principles that govern the Postal Service’s calculation of the incremental costs of its competitive products business. As the Commission is aware, parcel courier companies, including UPS, have an interest in that calculation being done in a manner that advances the objectives of 39 U.S.C. § 3633. Market-dominant mailers have that interest as well. Accordingly, UPS feels obliged to comment herein both on the narrow technical changes proposed, as well as the broader analytical principles applied by the Postal Service to estimate incremental costs overall.

The first proposed change involves a procedure for how the Postal Service will begin estimating the incremental cost for the group of all competitive products in the aggregate, replacing an earlier hybrid approach that relied on separate estimates for domestic and international competitive products. The Postal Service prepares this estimate of incremental cost as part of its effort to comply with 39 U.S.C. § 3633(a)(1),

¹ Petition of the United States Postal Service for the Initiation of a Proceeding to Consider Proposed Changes in Analytical Principles (Proposal Three) (“Petition”), Dkt. No. RM2018-6 (June 1, 2018), at 1.

which requires the Commission to “prohibit the subsidization of competitive products by market-dominant products.”²

For the reasons discussed in the Postal Service’s petition, the proposed change does modestly improve current procedures. But even with this change, UPS respectfully submits that the Postal Service’s overall proposal to comply with 39 U.S.C. § 3633(a)(1) falls short. That is because this technical change does not address the deeper methodological shortcomings with the Postal Service’s approach to identifying the full set of costs that are caused by its competitive products business as a whole.

To avoid subsidization, the Postal Service must ensure that revenues generated by its competitive products business exceed *all* of the costs that are caused by (or are incremental to) to that business. The Commission has defined the “incremental costs” of competitive products as all of the costs that would be eliminated if the Postal Service “(hypothetically) discontinued” selling competitive products altogether.³ To UPS’s knowledge, however, the Postal Service has never conducted a systematic and comprehensive analysis of the full set of costs could be eliminated from the Postal Service’s overall costs if it no longer sold any competitive products. And the Postal Service certainly does not appear to have conducted any such analysis in recent years, when competitive products are responsible for a far greater portion of its business than ever before.

² *Id.* at 1, 3.

³ Order Proposing Regulations to Establish a System of Ratemaking, Dkt. No. RM2007-1 (Aug. 15, 2007), at 65 (“Incremental costs are the variable and fixed costs that would be eliminated if a product (or products) was (were) (hypothetically) discontinued.”). See *also United Parcel Serv., Inc. v. Postal Regulatory Comm’n*, 890 F.3d 1053, 1055 (D.C. Cir. 2018) (Costs incremental to the competitive products business are those “that would disappear were the Postal Service to stop offering those products for sale.”).

Moreover, the Postal Service's current methodology for estimating the "incremental cost" of competitive products (even as adjusted by the current proposal) does *not*, in fact, identify all the costs that would be eliminated if the Postal Service were to discontinue its competitive products business. Rather, in this Proposal, as in many others, the Postal Service takes the current structure and organization of its network as a given, and it focuses primarily on estimating how costs change in response to small increases or decreases in product volumes. This narrow approach fails to address how the cost, structure, and organization of the Postal Service's network and operations would change if its competitive products business went away entirely. Such a narrow approach may have been acceptable, even if imperfect, in an earlier era, when competitive products were less central to the Postal Service's overall business. But the limitations of this approach are far more glaring today.

The result of this methodological limitation is that the Postal Service greatly underestimates the incremental costs of its competitive products business. In 2017, for example, the Postal Service estimated that only about 19% of the Postal Service's total costs were incremental costs of competitive products.⁴ But that same year, competitive products amounted to approximately 40% of Postal Service volume by weight and 30% of revenue.⁵

UPS respectfully submits that the Postal Service could eliminate far more than 19% of its costs in the hypothetical world where it ceased delivering competitive

⁴ See United States Postal Service FY 2017 Annual Compliance Report, Dkt. No. ACR2017 (Dec. 29, 2017), at 68.

⁵ See United States Postal Service, REVENUE, PIECES, AND WEIGHT BY CLASSES OF MAIL AND SPECIAL SERVICES FOR FISCAL YEAR 3, 5 (2017).

products—especially given that the Postal Service now faces an environment where letter mail is in a sustained, and likely irreversible, decline. The Postal Service’s network and operations were originally built to deliver large quantities of letter mail across the nation. But the nation’s citizens simply do not send nearly as much physical mail as they used to. The Postal Service is thus increasingly shifting its operations to deliver more e-commerce packages (*i.e.*, competitive products) while its mail volumes decline.

The Postal Service acknowledged that, in 2017, “mail volumes declined by approximately 5.0 billion pieces, or 3.6 percent, while package volumes grew by 589 million pieces, or 11.4 percent, continuing a multi-year trend of declining mail volumes and increasing package volume.”⁶ At the same time, the Postal Service states that it delivers “more e-commerce packages to the home than any other shipper,”⁷ has been delivering “one-third of all domestic packages in the United States,”⁸ and has enjoyed competitive volume growth of over 200% since 2007.⁹ Clearly this focus on package deliveries is driving much of the Postal Service’s size and operations today.

If the Postal Service stopped delivering any packages at all, and was only delivering declining volumes of letter mail, it would be able to reconfigure and reduce

⁶ *U.S. Postal Service Reports Fiscal Year 2017 Results* (Nov. 14, 2017), USPS NATIONAL NEWS, https://about.usps.com/news/national-releases/2017/pr17_069.htm.

⁷ *U.S. Postal Service Reports Fiscal Year 2016 Results* (Nov. 15, 2016), USPS NATIONAL NEWS, https://about.usps.com/news/national-releases/2016/pr16_092.htm.

⁸ *Reforming the Postal Service: Finding a Viable Solution: Hearing Before the House Oversight and Government Reform Committee*, 114th Cong. 10 (May 11, 2016) (statement of Megan J. Brennan, CEO of United States Postal Service).

⁹ *Compare* POSTAL REGULATORY COMMISSION, ANNUAL COMPLIANCE DETERMINATION: U.S. POSTAL SERVICE PERFORMANCE (FISCAL YEAR 2007) 24 (2007) (“Total Competitive Mail” of 1.63 billion pieces), *with* UNITED STATES POSTAL SERVICE, PUBLIC COST AND REVENUE ANALYSIS (FISCAL YEAR 2017) 5 (2017) (“Total Competitive Mail” of 5.10 billion pieces).

virtually every aspect of its operations. Under a proper economic analysis, *all* of those costs the Postal Service could save in that hypothetical world where it does not deliver competitive products should be included within the estimate of the incremental costs of competitive products. Such costs exist *only because* the Postal Service chooses to deliver competitive products.

Because the Postal Service has not investigated what costs it could eliminate if it stopped selling competitive products, market-dominant mailers may well be covering costs that would not exist if the Postal Service ceased delivering competitive products. Such cross-subsidization would not comply with the Postal Accountability and Enhancement Act (“PAEA”) and this Commission’s prior rulings.¹⁰ Accordingly, the Commission should approve the first proposed change in this docket but only as an interim measure, and it should direct the Postal Service to conduct a comprehensive analysis of *all costs* that could be saved if it stopped delivering competitive products altogether.

The second proposed change in this docket involves the use of an approximation method to calculate the incremental costs for the largest negotiated service agreement (“NSA”) products, while continuing to assume for the vast majority of the NSA products that volume variable costs are an acceptable proxy for incremental costs. While UPS is sympathetic to the concerns expressed by the Postal Service, it has reservations about its proposed approach. The approximation method for the largest NSAs is imperfect,

¹⁰ See, e.g., 39 U.S.C. § 3633(a)(1); Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, Dkt. No. RM2017-1 (Feb. 8, 2018), at 75 & n.121 (noting that the incremental cost test is meant to “prevent market dominant products from cross-subsidizing competitive products”).

but represents a step forward from the status quo, which (through FY16) had been to assume that volume variable costs are an acceptable proxy for incremental costs for all NSAs. As discussed below, UPS recommends an adjustment to the conditions that determine the set of NSA products for which the proxy calculation is performed, in order to provide an additional safeguard against cross-subsidization.

ARGUMENT

I. THE POSTAL SERVICE DOES NOT RELIABLY ESTIMATE THE INCREMENTAL COSTS OF COMPETITIVE PRODUCTS IN THE AGGREGATE

A. The Postal Service's Current Incremental Cost Methodology Falls Short of Capturing All Costs Incurred by Competitive Products

In Gerald Faulhaber's seminal article regarding the potential for cross-subsidization by public enterprises, the incremental cost associated with a product or group of products is defined as the total cost of the multi-product public enterprise, less the total cost of a counterfactual public enterprise that continues to supply all other products except those in the group whose incremental cost is being considered.¹¹ This measure can be expressed mathematically as $C(q^N) - C(q^{N-S})$, where C is the Postal Service's cost function, N refers to the entire set of products produced by the enterprise, and S refers to the set of products whose incremental cost is being calculated.

Faulhaber provided an example of a hypothetical water company serving four neighborhoods. The water company incurs joint fixed costs, group-specific fixed costs, neighborhood-specific fixed costs, and marginal pumping costs. Faulhaber recognized

¹¹ Gerald R. Faulhaber, *Cross-Subsidization: Pricing in Public Enterprises*, 65 AM. ECON. REV. 966, 969 (1975). The test as articulated by Faulhaber can equivalently be applied to a public enterprise serving different customer groups, which was the case in the example he developed in his article. As he stated, "the revenues contributed by the set of neighborhoods $S \subseteq N$ should be at least as great as the added cost of supplying S , in order to be subsidy-free." *Id.*

that such a company would alter its operations depending on which set of neighborhoods it must service. For example, a company selling water only to Neighborhood A would likely be structured quite differently from a company selling water to Neighborhoods A and B. The former would be able to consolidate its operations in the vicinity of Neighborhood A for more efficient maintenance and delivery, while the latter must consider coverage of a broader geographic area. As an economic matter, the incremental costs of serving neighborhood B would be the difference in total cost between these two configurations.

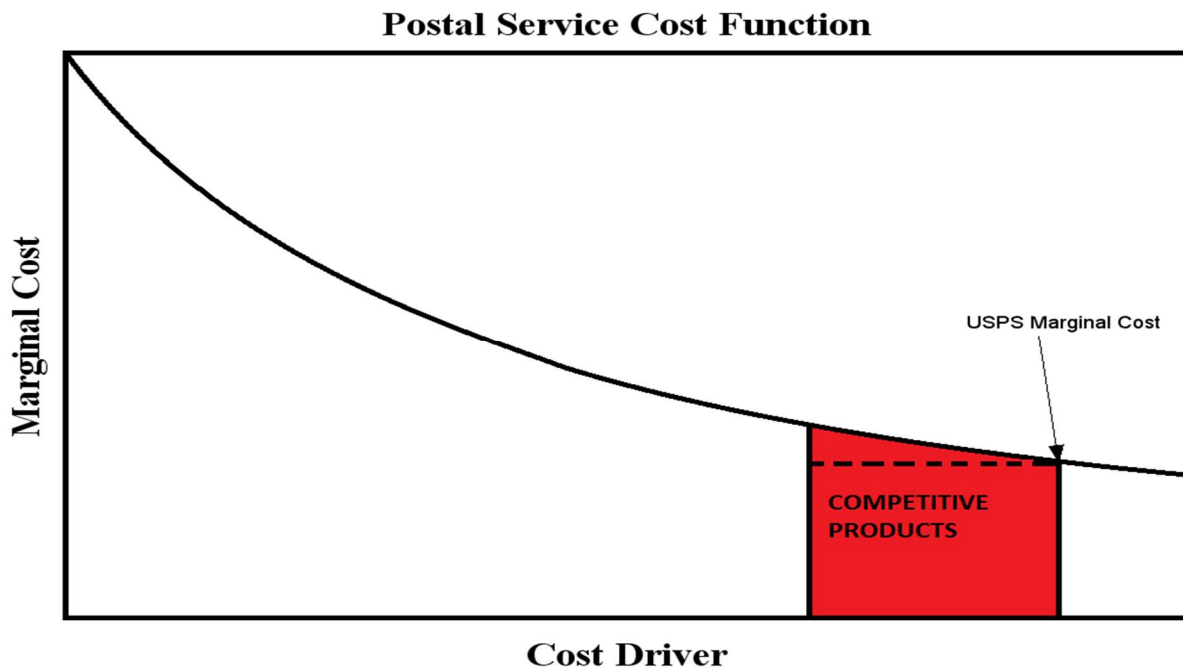
Thus, incremental cost as an economic matter requires consideration not just of the short-term costs that could be avoided if a company stopped selling a certain product set, but also the costs that could be avoided by an efficient reorganization of the enterprise itself.¹² Faulhaber does *not* distinguish between costs that would be avoided in the short-run versus those that would be avoided in the long-run; costs that would be generally regarded as sunk (such as the cost associated with some capital expenditure such as a neighborhood distribution system) are included in Faulhaber's measure of incremental cost, along with the short-run variable costs associated with pumping additional water.

The Postal Service has not followed these principles in its own efforts to estimate the incremental cost of competitive products in the aggregate. In calculating such costs, the Postal Service does not examine or estimate how the structure of the Postal Service would change if it eliminated its competitive products business altogether. Instead, the

¹² *Id.* at 969–70.

Postal Service calculates incremental costs (to the extent they depart from marginal or volume variable costs) based on one of several more narrow, mechanistic approaches.

The primary approach utilizes a constant elasticity assumption to estimate what the Postal Service's cost structure would look like if its volumes decreased.¹³ The following figure is instructive:



The Postal Service estimates “incremental” costs as the rectangular region (labeled “competitive products”) along with any “inframarginal” costs above the rectangular region but under the cost curve. This approach results in an understated measure of incremental costs because it *assumes* that the overall size, structure, and organization of the Postal Service network remains constant, unaffected in any way by the posited reduction in delivery volumes. This assumption is obviously incorrect—as

¹³ The Postal Service also uses a “piggyback” approach for some cost pools and some specialized models for others.

noted above, if the Postal Service no longer sold any competitive products, it could drastically reduce the overall size, structure, and organization of the enterprise.

Estimation of product- and group-specific costs could in theory allow for a more complete accounting of some of the differences between marginal cost and incremental cost. But the current interpretation of “product-specific” costs similarly limits such costs to those that are uniquely caused by a single product—*based on current operations*. For example, in an analogous context, the Postal Service has explained that in order for a financial obligation to be related to competitive products, “the activity in question would need to relate solely to the provision of a single competitive product, or solely to the provision of multiple competitive products,” further explaining that “equipment purchased to improve package handling generally is used in the provision of both market dominant and competitive package services,” and is thus not specific to competitive products.¹⁴ The Postal Service has argued that it is “simply follow[ing] the provisions of the Commission’s rules” in this regard.¹⁵ Under this narrow interpretation, which is also reflected in the calculation of product- and group-specific costs, the Postal Service’s group-specific costs for its competitive products business, which generates \$20 billion in annual revenue, totaled a mere \$43 million.¹⁶

In a prior docket considering the “appropriate share” of institutional costs that competitive products should be required to cover, UPS submitted the declaration of the

¹⁴ See Responses of the United States Postal Service to Questions 1–15 of Chairman’s Information Request No. 8, Dkt. No. ACR2017 (Jan. 29, 2018), at Q.5(a) (discussing the Competitive Products Fund Reporting Materials).

¹⁵ Reply Comments of the United States Postal Service, Dkt. No. ACR2017 (Feb. 12, 2018), at 30.

¹⁶ United States Postal Service FY 2017 Annual Compliance Report, Dkt. No. ACR2017 (Dec. 29, 2017), at 68.

economist Dennis Carlton who explained why the current approach utilized by the Postal Service does not fully reflect the incremental costs of competitive products in the economic sense.¹⁷ Professor Carlton explained that the Postal Service's classification of incremental costs "based on an extrapolation of estimated marginal costs (using a constant elasticity assumption)" generally "understate[s] incremental costs as defined by economists."¹⁸ Specifically:

[T]his methodology does not fully attempt to evaluate how costs would change if USPS modified the structure of its network in response to dropping provision of competitive products, as is necessary for estimating incremental costs. In such circumstances, an efficient firm would be likely to reconfigure its network—perhaps by, among other things, modifying delivery carriers' routes and/or by changing the number and location of processing facilities. In fact, if USPS stopped providing competitive products it would be expected to make significant changes to its network that would be likely to result in significant reductions in cost. USPS' incremental cost test, however, would fail to fully account for the extent of savings due to changes in network structure and thus understate incremental costs.¹⁹

Professor Carlton emphasizes that the Postal Service's current incremental cost methodology is thus incomplete:

[T]he economic literature defines incremental costs to include all additional costs incurred by a multiproduct firm in providing a given product or service. In the USPS context, the incremental costs of providing competitive services should reflect the difference between all costs incurred due to USPS' provision of both competitive and market dominant products, less the costs USPS would face [if it] only provided market dominant products. USPS' incremental cost framework does not appear to account for all costs that would be avoided if USPS did not provide competitive products. By failing to account for all costs incurred as the result of USPS' decision to provide competitive products, USPS' estimates

¹⁷ See Declaration of Dennis W. Carlton ("Carlton Decl."), Dkt. No. RM2017-1 (Mar. 9, 2017) ("Carlton Decl.") at 19–30.

¹⁸ *Id.* at 21.

¹⁹ *Id.* at 23.

will systematically understate true incremental costs, as defined in the economic literature.²⁰

In sum, as Professor Carlton explains, the Postal Service's current incremental cost methodology incorrectly assumes that the structure and organization of its network is fixed and would be unaffected by a decision to discontinue all competitive products.

In the absence of a competitive products' business, the Postal Service would be able to modify the structure of its delivery network, such as by "modifying delivery carriers' routes and/or by changing the number and location of processing facilities."²¹ Similarly, exiting the competitive products business would also decrease expenses for data processing supplies and services.²² These costs totaled \$811 million in FY17—but the Postal Service considers them to be almost entirely institutional.²³ For similar reasons, the Postal Service would not need as many large-capacity trucks designed to hold packages,²⁴ or as many peak season workers²⁵ if it were no longer in the business of delivering competitive products.

²⁰ *Id.* at 21; see also Gerald L. Faulhaber, *Cross-Subsidy Analysis with More Than Two Services*, 1 J. COMPETITION L. & ECON. 441 (2005) ("The incremental cost of a service or group of services is the additional cost of providing that service or group of services over and above the cost of providing all the remaining services."); Faulhaber, *supra* note 11, at 969 ("[R]evenues contributed by [products] should be at least as great as the added cost of supplying the [products], in order to be subsidy-free. . . . [This] has been called the incremental cost test.").

²¹ Carlton Decl. at 23.

²² *Id.* at 22.

²³ *USPS-FY17-2 - FY 2017 Public Cost Segments and Components Report*, Dkt. No. ACR2017 (Dec. 29, 2017) (showing that Cost Segment 16.3.4.1 reports \$811 million of total costs and that all but \$15 million is treated as institutional costs).

²⁴ See, e.g., Larry P. Vellequette, *Postal Service To Buy 9,113 Ram ProMaster Vans for Large Package Delivery*, AUTOMOTIVE NEWS (Sept. 29, 2015), <http://www.autonews.com/article/20150929/RETAIL/150929815/postal-service-to-buy-9113-ram-promaster-vans-for-large-package>; *Car and Carrier: USPS Looks for the Next Generation Delivery Vehicle*, THE POSTAL RECORD, Aug. 2017, https://www.nalc.org/news/the-postal-record/2017/august-2017/document/08-2017_car.pdf (discussing specifications for the Postal

The Postal Service would also be able to buy cheaper delivery vehicles instead of the larger, and more expensive, “UPS-sized” vehicles it is currently purchasing.²⁶ (While there is a small share of parcel volume that consists of market-dominant products, parcels are, by and large, competitive products.²⁷) The Postal Service would almost certainly not need to purchase these more expensive, larger vehicles if it was not delivering competitive products. Thus, the additional cost associated with these larger vehicles (as opposed to a modern version of the traditional postal vehicles that have been used to deliver letter mail for decades) is the very definition of a cost that is incremental to competitive products. Instead, depreciation on brand new city carrier vehicles is attributed in the exact same way as depreciation on the existing city carrier fleet.²⁸

Service’s Next Generation Delivery Vehicle and noting that the Postal Service will require the next delivery vehicle to be large enough that “[l]etter carriers [are] able to stand up in the vehicle and walk to the rear of the vehicle, where more room for packages is expected”).

²⁵ *Seasonal Hiring – 2016*, USPS, <https://about.usps.com/news/statements/093016.htm> (“This holiday season, the Postal Service plans to hire between 35,000 and 40,000 seasonal workers to process and deliver holiday cards and packages to our customers.”).

²⁶ Mike Colgan, *Familiar White Postal Service Trucks Too Small for Increasing Amount of Parcels Being Mailed*, CBS SF BAY AREA (Jan. 19, 2015, 3:45 PM), <http://sanfrancisco.cbslocal.com/2015/01/19/familiar-white-postal-service-trucks-too-small-for-increasing-amount-of-parcels-being-mailed>; see also sources cited *supra* note 26.

²⁷ UPS is not aware of any publicly available data that indicates the aggregate share of parcels that belong to a given product, but delivery distribution keys provide some indication. In city carrier delivery, domestic market-dominant mail accounts for 17% of the small parcels distribution key and 9% of the large parcels distribution key. See *USPS-FY17-32 - FY 2017 CRA “B” Workpapers*, Dkt. No. ACR2017 (Dec. 29, 2017), USPS-FY17-32\B Workpapers\CS06&7-Public-FY17.xlsx. In rural carrier delivery, domestic market-dominant mail accounts for 10% of the parcels delivery distribution key. See *USPS-FY17-32 - FY 2017 CRA “B” Workpapers*, Dkt. No. ACR2017 (Dec. 29, 2017), USPS-FY17-32\B Workpapers\CS10-Public-FY17.xlsx.

²⁸ *Compare* Responses of the United States Postal Service to Questions 1–15 of Chairman’s Information Request No. 8, Dkt. No. ACR2017 (Jan. 29, 2018), at Q.4(b), with *USPS-FY17-2 - FY 2017 Public Cost Segments and Components Report*, Dkt. No. ACR2017 (Dec. 29, 2017), tab <<CS20>>. For example, both indicate that roughly 5.3% of the vehicle

Similarly, the Postal Service has been retaining vehicles originally slated for replacement due in part “to continued growth in package volume.”²⁹ The 7,688 retained vehicles resulted in an additional \$19.6 million in maintenance costs—costs that likely would have been saved if the Postal Service was not delivering packages. The Postal Service, however, does not include these costs in the cost pool of vehicle service; they are instead attributed using the same labor-based distribution keys used to attribute other costs. The result is that only 5.3% of such costs allocated to city carrier letter routes are then attributed to competitive products—even though 100% of these costs would likely go away if the Postal Service did not deliver any competitive products.

The hypothetical elimination of the competitive products business would also allow the Postal Service to “reduce certain headquarters expenses relating to administration and management.”³⁰ These costs totaled \$839 million in FY17—but the Postal Service does not attribute them to individual domestic competitive products; instead classifying them mostly as institutional.³¹ With more than \$20 billion in revenue and 846 domestic competitive NSAs in effect in FY17, it is clear that the competitive

depreciation expenses assigned to city letter routes is attributed to competitive products and that roughly 26% of the vehicle depreciation expenses assigned to city special purpose routes are attributed to competitive products.

²⁹ USPS OFFICE OF INSPECTOR GENERAL, REVIEW OF EXTENDED CAPACITY LEFT-HAND DRIVE DELIVERY VEHICLE ACQUISITION, Rpt. No. MI-AR-18-002 (May 18, 2018) at 1, 4, <https://www.uspsoig.gov/sites/default/files/document-library-files/2018/MI-AR-18-002.pdf>. The other reason cited for the retention of these vehicles was “an increase in delivery points beyond projections.” *Id.* However, the number of delivery points grew by less than 0.8% from FY16 to FY17, a growth rate commensurate with recent history. See *A Decade of Facts & Figures*, USPS POSTAL FACTS, <https://facts.usps.com/table-facts/>.

³⁰ Carlton Decl. at 21–22.

³¹ *USPS-FY17-2 - FY 2017 Public Cost Segments and Components Report*, Dkt. No. ACR2017 (Dec. 29, 2017) (showing that Cost Segment 18.1.1 reports \$839 million of total costs and that all but \$14 million is treated as institutional costs).

products' business occupies a significant share of managerial attention.³² What is less clear is how the managerial, marketing, legal, and other administrative costs associated with oversight of a \$20 billion competitive enterprise are accounted for and attributed.

There are many such examples, the key point is that the Postal Service's methodology for estimating the incremental cost of competitive products as a group does not capture all of the costs that could be avoided if the Postal Service stopped selling competitive products. The current narrow approach is thus insufficient to prevent cross-subsidization.

B. The Commission Should Direct the Postal Service to Properly Measure Incremental Costs

As discussed above, the minor procedural change proposed in this docket does not address the central question that should form the basis for any incremental cost calculation: How would the Postal Service's network, structure, and organization change if its competitive products business were discontinued and what costs could be eliminated?

To remedy this, the Commission should undertake a study with the goal of developing a systematic and comprehensive estimate of all of the costs that would be shed by the Postal Service in a hypothetical world in which it only delivers the mail (and other market-dominant products). Obtaining this information would allow the Postal

³² While the Postal Service has stated in its petition that there were 489 domestic competitive NSA *products* in effect in FY17, the Annual Compliance Determination suggests there were 846 competitive domestic NSAs. *Compare* Petition at 11–12, *with* POSTAL REGULATORY COMMISSION, ANNUAL COMPLIANCE DETERMINATION REPORT (FISCAL YEAR 2017) 84 (2017) ("*2017 Annual Compliance Determination*"), available at https://www.prc.gov/docs/104/104398/2017_ACD.pdf (listing 846 NSA products in Table IV-1, but indicating that the 316 NSAs entered into under the Priority Mail – Non-Published Rates product are not considered to be separate products).

Service to ensure, consistent with PAEA, that market-dominant products are not covering costs that exist only because of competitive products.

UPS notes that nearly ten years ago the Commission approved interim measures for estimating group-specific costs which the Commission stated could “be used as one component of an *interim measure* of the incremental costs of the competitive product group *until a systematic and comprehensive estimate of those costs can be developed*.”³³ Nearly a decade later, those interim measures are apparently still in place, and that “systematic and comprehensive” analysis has not been performed. The need for this analysis is now more urgent than ever, given how central competitive products are today to the Postal Service’s business. The Commission may need to solicit input from various experts in order to establish a holistic view of what this counterfactual organization would look like. The Postal Service itself may well have conducted analyses that would be helpful to answer this question.

II. PROCEDURE ONE REPRESENTS A MINOR STEP FORWARD

As an interim measure, however, UPS does support Procedure One as a minor improvement over the status quo and recommends implementing it until a more satisfactory methodology for identifying incremental costs of competitive products is established.

Prior to FY2017, the Postal Service sought to comply with 39 U.S.C. § 3633(a)(1) by adopting a “hybrid” approach to calculating incremental costs for competitive products. This “hybrid” approach entailed calculating—and adding—two separate

³³ Order Accepting Certain Analytical Principles for Use in the Postal Service’s Periodic Reports, Dkt. No. RM2008-2 (Oct. 10, 2008), at 14 (emphasis added).

buckets of costs: (1) incremental costs for *domestic* competitive products that included inframarginal costs and added to it the results of a calculation of the volume variable costs, plus (2) attributable costs for *international* competitive products, which *did not include* their inframarginal costs (due to difficulties in separating international cost data between market-dominant and competitive products).³⁴ The need for the hybrid approach stemmed from the structure of the International Cost and Revenue Analysis (“ICRA”), which precluded direct application of the established cost models to international products.³⁵

Procedure One addresses this problem by relying on the Postal Service’s efforts to “split international cost information within cost pools between market dominant and competitive products,” which came about as a result of the implementation of a cost proposal in RM2016-10 that harmonized CRA and ICRA methodologies.³⁶ To the extent errors exist in cost models for international mail, those errors will be ported into this calculation as well.³⁷ Nonetheless, UPS supports Procedure One as an interim measure in the right direction until a more complete methodology is put in place.

³⁴ Petition at 2–4.

³⁵ United States Postal Service FY2017 Annual Compliance Report, Dkt. No. ACR2017 (Dec. 29, 2017), at 67.

³⁶ Petition at 6. Although Procedure One does not address the calculation of incremental costs for *individual* international products, the Postal Service claims it is precluded from calculating such costs by “the complexity of crosswalking costs for the international mail classes developed in USPS-FY17-NP4 with the costs for the final international product groupings reported in the CRA Report (as filed in USPS-FY17-NP11).” *Id.*

³⁷ See *2017 Annual Compliance Determination*, *supra* note 32, at 69 (“The Commission finds that FY 2017 revenue for Inbound Letter Post was not sufficient to cover attributable cost. The Commission directs the Postal Service, within 90 days, to submit an update on its collection of accurate shape-based data, and development of costing models for Inbound Letter Post using this shape-based data if it has not yet filed a rulemaking proposal to implement shape-based costing for Inbound Letter Post in the Domestic Processing Model and the ICRA.”).

III. PROCEDURE TWO (PROXY COST DRIVER FOR NSA INCREMENTAL COSTS) REQUIRES MODIFICATIONS

The Postal Service's proposed Procedure Two generally improves on the current method used to calculate the incremental costs for individual NSA products. However, UPS recommends a modification of the proposal that will provide an additional safeguard against the risk of cross-subsidization.

Under the current methodology, the calculation of incremental costs for a given product (or group of products) in any cost pool should be based on the share of the cost driver caused by that product.³⁸ The Postal Service has explained, however, that because it calculates volume variable costs for NSA products on an aggregated basis outside of the CRA, the Postal Service does not know each NSA's share of the cost driver in individual cost pools.³⁹ The Postal Service also notes, correctly, that small-volume products will tend to comprise smaller shares of the cost driver in any given cost component, and thus that the relative difference between marginal cost and incremental cost for small-volume NSA products will be smaller than it is for products that comprise a larger share of the cost driver in that component.⁴⁰

Accordingly, Procedure Two purports to address the data shortcoming identified above by using a "proxy cost driver" to calculate the incremental costs for NSA Products, but to only do so for the largest NSAs. Specifically, the proxy approach would approximate the share of the cost driver by assuming that an NSA product's share of

³⁸ Petition at 12.

³⁹ *Id.* at 15–16.

⁴⁰ *Id.* at 8–9.

total volume variable cost is an acceptable approximation for that product's share of the cost driver.⁴¹ This proxy method would be applied to those domestic competitive NSAs that meet one of two size thresholds, both based on the NSA's volume variable cost:

- NSAs with at least 0.3 percent of the product type's volume variable cost; and
- NSAs with at least \$8 million in volume variable cost.⁴²

For NSA products that do not meet either size threshold, the Postal Service would continue to use volume variable costs as its measure for incremental costs as it tests compliance with 39 U.S.C. § 3633(a)(2).

According to the Postal Service, 32 out of approximately 500 NSAs met one or both thresholds in FY2017, though the Postal Service calculated incremental costs for a "minimum of five NSAs for each product type."⁴³ The Postal Service has argued that the volume variable cost ratio that it seeks to use in its proxy approach is "the best approximation available."⁴⁴ In FY2017, it applied this proxy approach to estimate product-level inframarginal (and thus incremental) costs.⁴⁵ UPS believes that Procedure Two is imperfect, but represents a small improvement over the status quo,

⁴¹ *Id.* at 16.

⁴² *Id.* at 11. Table IV-1 of the Annual Compliance Determination indicates that there were 101 Competitive Domestic NSA products in effect during FY17 that covered more than one product. *2017 Annual Compliance Determination*, *supra* note 32, at 84. For example, there were 46 products described as Priority Mail & First-Class Package Service Contracts, and 18 products described as Priority Mail Express, Priority Mail & First-Class Package Service Contracts. It is not clear how the Postal Service intends to apply its proposed thresholds to these products.

⁴³ Petition at 11–12.

⁴⁴ *Id.* at 16.

⁴⁵ USPS-FY17-42 - FY 2017 Revenue, Pieces, and Weight Report: Preface, Dkt. No. ACR2017 (Dec. 29, 2017).

which, by ignoring inframarginal costs, introduces a downward bias into the incremental cost calculations for *all* individual NSA products. Although there are inaccuracies that result from assuming that an individual product's share of the product type's cost driver are the same across all relevant cost pools, UPS appreciates that there are genuine difficulties in identifying precise cost driver shares for all NSA products and cost pools.⁴⁶ As such, the "proxy cost driver" approach represents an improvement over the approach employed in FY2016, which did not provide any inframarginal cost estimates for individual NSA products.

UPS has some concerns regarding the determination of the set of NSAs for which the proposed calculation is performed. First, the Postal Service implies that applying the proxy calculation to small-volume NSAs would be burdensome. But it is unclear how much additional work it would require to perform the calculations described above for *all* NSAs. The inputs for such a calculation are already created in the course of preparing the Postal Service's ACR filings. Specifically, the Postal Service has proposed the following formula as its proxy measure for the incremental costs of large-volume NSA products (here expressed for Priority Mail contract 50):⁴⁷

$$IC_{PM50} = \sum_i^n \alpha_i D_i^{\varepsilon_i} \left[1 - \left(1 - \left(\frac{D_{i,PM}}{D_i} \right) \psi_{PM50} \right)^{\varepsilon_i} \right]$$

⁴⁶ For example, if two NSAs for a given product type have identical volume variable costs but the distribution of those costs across the set of constant elasticity cost pools differs, then a full incremental cost calculation with actual cost driver share data would generally yield differences in the incremental costs of the two products. The proxy cost driver approach could either have the effect of overstating or understating the incremental cost of a given NSA product, depending on the (unknown) true cost driver shares in various cost pools.

⁴⁷ Petition at 16.

The only term on the right-hand side of that expression that is specific to the NSA in question (here, Priority Mail contract 50) is ψ_{PM50} , which is in turn equal to $\frac{VVC_{PM50}}{VVC_{PM}}$. However, VVC_{PM50} , and the volume variable cost totals for all NSAs, including small-volume NSAs, are already calculated in the course of the prevailing methodology for assessing compliance with 39 U.S.C. § 3633(a)(2). If the Postal Service intends to calculate its proxy for incremental costs for a minimum of five NSAs for each product type, the marginal work needed to calculate the same proxy for the remaining NSAs of that product type should be minimal.⁴⁸

That said, UPS agrees with the core threshold proposal that is part of Procedure Two: The calculation of an approximate measure of incremental costs, as opposed to the continued use of volume variable costs as a substitute measure, is more likely to make a difference for some products than it is for others. For many of the nearly 500 NSAs that do not meet the thresholds specified by the Postal Service, the use of volume variable cost as a downwardly biased measure of incremental cost will have limited bearing on the outcome of the product-level cross-subsidy test performed under 39 U.S.C. § 3633(a)(2), as the bias would in many cases be small.

But UPS also believes that to the extent that the Postal Service is permitted to perform the full calculation on only a subset of NSA products, the thresholds for determining that subset should not be based solely on volume variable cost. Under Procedure Two, the Postal Service's proposed approach requests the approval to use a volume variable cost proxy for incremental costs for any NSAs that both comprise less

⁴⁸ This would usually consist of having a computer program execute identical calculations using inputs corresponding to the additional products. It would be equivalent to adding additional lines to an existing spreadsheet.

than 0.3% of the volume variable cost for a given product type and have less than \$8 million in volume variable costs. Adoption of this approach would mean accepting a downward-biased measure of incremental costs for NSA products whose collective costs account for as much as several billion dollars.⁴⁹

The Postal Service's petition has correctly argued that the size of the downward bias entailed by using the volume variable costs is closely related to the amount of volume variable costs. The Commission's concern in enforcing the incremental cost test, however, is not just the size of the bias, but also the likelihood that a more accurate accounting for incremental costs might alter conclusions about whether individual NSAs are fully covering their incremental costs. Given that the Postal Service already calculates product-level revenues and product-level volume variable costs for each NSA that the Commission considers as a separate product, the cost coverage of revenues over volume variable costs for all NSAs should be known. If the cost coverage implied by the ratio of revenue to volume variable costs for a given low-volume product is low enough, the Postal Service should calculate its incremental cost, regardless of its volume.

Therefore, UPS urges the Commission to adopt an additional threshold: The Postal Service should *also* calculate the proxy measure for incremental costs that they have proposed for NSA products whose ratio of revenue to volume variable costs is less than 105%, regardless of size. Adding this third appropriate threshold is unlikely to greatly increase the number of products for which the Postal Service must perform the

⁴⁹ According to the Postal Service, there were 457 domestic competitive NSAs that failed to meet either threshold. In the absence of additional information, this generates a potential upper bound of $457 \times \$8 \text{ million} = \3.656 billion in volume variable costs.

“proxy cost driver” calculation, but this threshold would add an additional safeguard for those NSA products that are only barely covering volume variable costs, thus reducing the risk of cross-subsidy.

CONCLUSION

For the reasons discussed above, the Postal Service is failing to use methods that identify the full set of costs that are truly caused by competitive products. The Commission should take appropriate steps to correct this problem. Until that is done, Proposal Three makes technical changes that are a minor step in the right direction, although the second proposed change (regarding NSAs) should be modified to include an additional threshold to use in determining the subset of NSA products for which the Postal Service should perform its proxy incremental cost calculation.

Respectfully submitted,

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